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The Right Way to Break Up the Banks

Rep. Brad Miller

Daniel Tarullo, a respected and independent member of the Federal Reserve, has now concluded that the megabanks are too big and that Congress should do something about it.

Presumably he is referring to legislation that Sherrod Brown of Ohio introduced in the Senate and I proposed in the House to cap the size of banks. Senator Brown and I welcome Governor Tarullo as an ally.

He needn't just look to Congress. Regulators already have the power to cure many ills of too-big-to-fail banks. Lenders would effectively break up in place if their subsidiaries -- or at least some of them -- operated as truly separate corporations.

The nine biggest bank holding companies together have almost 20,000 subsidiaries. JPMorgan Chase & Co. (JPM) has 3,391 subsidiaries; Goldman Sachs Group Inc. (GS) has 3,115; Morgan Stanley (MS) has 2,884; Bank of America Corp. has 2,019; and so forth. Each of the seven biggest bank holding companies has units in at least 40 countries. Goldman Sachs has 1,670 subsidiaries abroad.

Lehman Brothers Holdings Inc., with about 8,000 units, left them all in the shade. More subsidiaries are apparently not an indicator of better management.

In theory, each unit is a separate corporation. The stock of the subsidiaries is owned, directly or indirectly, by a parent corporation.

Limiting Liability

Bank holding companies create subsidiaries for tax or regulatory purposes, but rarely to limit liability, the usual reason for creating corporations. The liability of a corporation is limited to the assets of the corporation where the corporation meets certain legal requirements. The corporation must observe the formalities of corporate law, such as having a board of directors.

The assets of the corporation must be kept separate, rather than commingled with those of others. The capital of the corporation must be reasonably adequate for its business. Most important, the corporation must present itself as a separate entity, so any business partners know its obligations will only be satisfied by that corporation's assets.

In practice, bank holding companies' subsidiaries do little of that. The holding companies operate as a single enterprise with consolidated management and a common pool of capital and liquidity.

In short, each of the megabanks is just one big sloppy mess of an enterprise, with every subsidiary on the hook for the liability of the parent corporation and all of the siblings. The megabanks regard that as a virtue.

Bank executives sometimes justify the combination of logically distinct businesses -- mortgage servicing, credit cards, home-equity lines of credit, derivatives trading -- into one enterprise by claiming "synergies," the business advantages that other generations have sometimes called "conflicts of interest." More often, they claim the advantage of "liquidity." A subsidiary obtains credit not just on the strength of that corporation's assets, but on those of the holding company.

That is a nightmare for bank supervision. A regulator has no realistic way to assess the risk

posed in thousands of subsidiaries engaged in all manner of businesses with unlimited liquidity, and the experience of American International Group Inc. teaches that the liability of one relatively small subsidiary can matter.

Some existing laws -- Section 23A of the Federal Reserve Act, the Volcker rule and the "pushout" rule for swaps trading -- try to isolate certain riskier activities from insured deposits, but none protects nonbank units from each other.

Bair's Challenge

Sheila Bair, in her book "Bull by the Horns," argues that regulators have the authority under the "living wills" provision in the Dodd-Frank law to require systemically important financial institutions to restructure "if they cannot show that their nonbank operations can be resolved in bankruptcy without systemic disruptions." According to Bair, megabank operations should be "simplified and subsidiarized" into "discrete, separately managed legal entities" based on business lines.

Bair said that breaking up megabanks entirely "is an attractive option," but she doubts "there is sufficient support in Congress for passing legislation to break them up." I'm sure she meant no disrespect to Senator Brown's and my legislative talents.

Stand-alone institutions would be easier to manage and supervise. They would also be far less messy to resolve. Even if the enterprise became insolvent, many subsidiaries could still operate relatively normally. Stand-alone units could be sold or spun off without significant disruption to the enterprise or to the financial system. They would also enlist the help of the market in supervising megabanks.

Market participants cannot realistically assess the assets and liabilities of a megabank any more than a regulator can. They assume that megabanks are still too big to fail, so they will get paid one way or another. If market participants knew they could be paid only from the assets of the specific subsidiary with which they did business, they would consider that subsidiary's assets and potential liabilities.

That diligence is part of "market discipline," a drastic change from the unlimited liquidity for every line of business. Governor Tarullo really should consider requiring stand-alone subsidiaries under existing law, just in case Senator Brown's and my bill hits a snag.

(Brad Miller is a Democratic representative from North Carolina in the U.S. Congress. He serves on three subcommittees of the House Financial Services Committee. The opinions expressed are his own.)